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My name is William J. Rennicke, and I am a Vice President with Mercer Management Consulting, Inc. (Mercer). I have 30 years of experience consulting to the transportation industry on a wide range of regulatory, economic, litigation, and asset management issues. I specialize in transportation strategic planning, management, marketing, economics, and operations, and have particular expertise in restructuring, organizational redesign, and transactions to improve financial and operating performance of transport operators around the world. I have previously provided expert testimony on the state of the North American rail industry on several occasions before the U.S. and Canadian legislatures. I have also directed the analysis of the competitive effects of transactions before the FTC and DOJ.

My purpose in preparing this statement is to provide the Committee with Mercer's perspective on the worldwide trend towards private sector involvement in passenger railroad restructuring and privatization. My testimony is based on experience working with many of the national railways worldwide that have been restructured, privatized, or are otherwise seeking ways to attract private sector investment and improve both their finances and their services.

In the last ten years, there has been a radical change in the way passenger railroads around the world are structured and operated. A particular feature has been growing private sector involvement in all areas, from operating trains, through maintenance of rolling stock and infrastructure, to financing of large-scale projects. In general, the result has been very positive, with improvements in service and ridership, increases in investment and big reductions in subsidies.

Many of the lessons can be applied to the US passenger rail situation, although obviously each country is different, and we should be careful in applying wholesale a model used elsewhere, however successful.

Ten Years Ago

Ten years ago, around 1990, virtually all countries had large, integrated, state-owned railroads. The integrated railroads did everything - specifying, procuring and owning equipment and infrastructure, maintaining it, running passenger and freight services, operating stations and freight terminals, providing add-on services to customers, and managing all the associated administrative activities.

Many of the railroads were actually government departments, others some form of public corporation. In both cases, funding came from the government, usually through coverage of the annual operating deficit, and funding of the capital budget. Since governments are perennially short of money, capital spending was inadequate to replace assets, and the condition of the equipment and infrastructure was steadily deteriorating.

The only major private sector involvement was US freight railroads. Outside of US freight, private sector involvement was very limited.

Changes in the Last Ten Years

Since 1990, the railroad sector worldwide has undergone a radical change that is still continuing. The change has been driven by three related factors:

- Poor and declining performance by the railroads, including declining (or barely increasing) ridership, poor service (especially frequency and on-time performance), and increasing costs and financial support required.
- Financial pressures on governments that made the subsidy paid to railroads look a poor value use of public funds compared to alternative uses such as health and education.
- Frustration by governments at the lack of firm action by railroad management to address these problems, and at the intransigence of labor to adapt in ways that would assist performance.

The changes differed by country, depending in particular on how bad the situation was, the government's objectives and the level of skills available in the existing railroad staff to sort out the problems.

Unbundling

A common theme in all countries has been "unbundling". The integrated state-owned railroad comprised a series of activities - for example, financing the equipment, owning it, maintaining it, operating it, marketing the service to passengers - that together provide the service to customers.

Unbundling separates out these activities and gives them to the most efficient type of provider. So, financing and ownership of equipment may be done more efficiently by an operating lessor or a bank. Equipment maintenance may be done more efficiently by a specialist maintenance company, or by the manufacturer who understands the technology and can give a long-term commitment to equipment availability. Train operation may be done better by large bus operators who are skilled at providing high-frequency customer-oriented services.

Importantly, unbundling allows the private sector to become involved. No private sector companies have the experience to manage the full range of rail activities, but they can be very effective at managing pieces of it. Where there is a requirement to manage more than that, they can create consortium arrangements where each member does what he is good at and they all share in the overall risk and reward.

Private Sector Involvement

Private sector involvement has taken a variety of forms:

- Full or partial IPO of the railroad or unbundled parts of it. Examples include Canadian National, the Japanese railroad (split into regional operators), the UK infrastructure company Railtrack, and the subway operator MTRC in Hong Kong.
- Sale to private owners. Examples here include the New Zealand railroad and the UK freight operator (both sold to Wisconsin Central), the Argentinian freight lines (sold to local and US short line operators), and the UK passenger rolling stock and maintenance shops (sold to various banks and manufacturers).
- Concessions to operate services. Examples include Argentina passenger services (originally concessioned for seven years and now being extended to encourage re-investment), Swedish and German regional rail concessions (typically 3-10 years), and UK passenger franchises (7 years).
- Financing of new assets. This includes growing private sector leasing of rolling stock, and the financing of major infrastructure. Examples include the UK passenger rolling stock fleet (the ROSCOs), and FBOT (finance, build, operate, transfer) schemes such as the Dutch high-speed line, the high-speed Channel Tunnel Rail Link in the UK, and the Taiwan high-speed line.

As the examples show, it is not necessary to sell the whole system to get many of the benefits of private sector involvement. Many countries, particularly in Europe, are working toward a mixed model, where some activities, particularly management of infrastructure, will be state-run and others, particularly train services, will be run by the private sector. However, even state-run infrastructure activities will use the private sector, e.g., for maintenance or for financing major projects, as the normal part of doing business.

Country Case Examples

South America has seen the most radical changes in its railroads, with virtually all the region's railroads moving from state-owned to private sector in the last ten years. Argentina was the first country in South America (and in the world) to move to complete private sector railroads in 1993-5. At the time service was very poor, financial support was out of control, and poor asset condition threatened even basic operation. The government, with Mercer's

help, moved quickly to bring in private operation of all passenger and freight lines, and committed them to a program of asset improvement. Similarly in Mexico, the rapid devaluation of the peso forced the government, again with Mercer's help, to split up and concession the freight railroad in three pieces in record time, yielding over \$2.5 billion in one-off cash to the government.

In continental Europe, railroads were better run, and government financial pressures less. As a result, there has been a gradual evolution, pushed along by the European Commission. The succession of changes started with restructuring of the railroads while still in state ownership to make them more commercial, efficient and financially sound (and to separate infrastructure from train operations). It has now moved to greater private sector involvement and competition, with a requirement for commuter, regional and light rail systems to be offered to competitive concession, and plans to IPO the freight and inter-city passenger services in some countries. Similar changes are happening, more slowly, in Eastern Europe, as countries prepare to join the EU.

The UK, of course, followed a different path. The government unbundled the system into 100 separate pieces and privatized everything. The resulting complexity has caused problems, and contributed to the failure of Railtrack, but other parts have performed well, particularly the train operators, and the rolling stock management and maintenance.

Elsewhere, Japan is completing the privatization of its system, mainly through IPO of existing operators; Australia is concessioning most of its passenger and freight operations; and New Zealand sold off its railroad in the early 1990s. Even China is now reviewing options for unbundling and private sector involvement in its massive system, and Russia has recently restructured its railroad in preparation for privatization.

Emergence of Private Sector Companies

Parallel to these changes has been the emergence of private sector companies to take on the new roles. Ten years ago, governments had to search for companies with the right skills when they wanted to bring in the private sector. Now, there is a group of companies experienced in operating in the new unbundled rail industry.

There are four different types of new companies:

- Train operators. New passenger train operators are primarily French or British bus companies that started with UK rail privatization. They include Connex, National Express, Via GTI, First Group, Arriva and Stagecoach. They now hold concessions in the UK, Netherlands, Australia, Sweden, Portugal, Germany, and Denmark, including some high-speed services (over 125 mph).
- Maintenance companies. Infrastructure maintenance specialists have emerged mainly from construction companies and include Balfour Beatty and Jarvis of the UK, and Sersa of Switzerland. In rolling stock maintenance, manufacturers predominate, including Bombardier, Alstom and Siemens.

- Finance providers, including lessors (financial and operating), arrangers and commercial lenders. There is a large list of commercial lenders in Europe in particular that now have experience owning rail assets and lending to major railroad projects, and a growing understanding of how to assess and price the risks involved.
- BOT (build, operate, transfer) consortia. Consortia members include finance providers and train operators, but also other risk-taking companies such as project managers (e.g., Bechtel) and engineering consultants.

With their international experience with different rail operations, these new companies are increasingly transferring best practices from one country or operation to another.

Maximising Value from Private Involvement

As governments have developed private sector involvement, they have learned what conditions are required to maximize the value they get. Some of the conditions relate to attracting private sector bidders in an international marketplace where private companies have many other opportunities; others relate to ensuring ongoing value as the contract or concession progresses. The major conditions are:

- Clarity on the framework (political, institutional and legal) within which the private sector will operate. Without this, the private sector fears it will get squeezed by ever changing political pressures. In the UK, for example, the threat by the Labour party of re-nationalization put off bidders and considerably reduced the value the government obtained from the sale of the ROSCOs and the IPO of Railtrack.
- A structure of the business being offered that gives private operators sufficient breadth over which they can add value, and sufficient flexibility to make changes. Too narrow a set of activities and too many constraints (e.g., on service frequency, prices, or labor) reduces the private sector's ability to improve performance. Some private operators are not bidding for concessions in Europe because the concessions are too narrow and too short to make a decent return.
- Agreed, measurable and enforceable commitments on service and investment, which if met will deliver to government the benefits it needs. This effectively aligns the government's and the private operator's interests.
- Strong performance monitoring arrangements, including reporting and meaningful penalties/incentives which focus the private company's management and staff day-to-day. This needs to be coupled with a hands-off day-to-day management approach by government, which allows the company to manage in a normal commercial manner.

Results

In general, the results of the changes have been very positive. For example,

- In Argentina, ridership of the commuter system increased by 125% in the first seven years of the concessions (1993-2000), service improved dramatically, and subsidies for the commuter and metro systems combined reduced from \$300 million to \$50 million.
- In Mexico, in addition to the \$2.5 billion initial cash inflow, government subsidies of \$0.7 billion a year were eliminated. Freight traffic rose by 50% between 1995 and 2000 and a \$1.3 billion investment program was completed.
- In the UK, passenger and freight traffic increased by 25-40% in the first five years, subsidies for passenger services were committed to fall by 60% over the seven years of the franchises, and a major replacement program for passenger rolling stock is still underway.
- In passenger concessioning in countries such as Sweden, Germany and Australia, private operators are committing in their bids to operate the services with cost reductions of 20% or more, with a larger reduction in subsidy.

